No. 14579

United States
COURT OF APPEALS
for the Ninth Circuit

E. J. MURRAY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S REPLY BRIEF

Petition to Review a Decision of the Tax Court of the United States

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I.

Petitioner did not realize taxable income from the Murray v. Wiley litigation.

Respondent attempts to sustain the decision of the Tax Court that petitioner realized taxable income from the *Murray v. Wiley* litigation on two theories: (1) that petitioner procured for himself "an economic benefit from the application of the credit" in the judicial accounting, and (2) that "the credit in the accounting

procedure utilized by the state court should be regarded as if the taxpayer had recovered a judgment for the rents and interest." (Resp. Br. pp. 12-13). Both these theories will not stand analysis.

Underlying the first proposition is the assumption that an economic benefit of substance equivalent to taxable income was realized. We do not understand respondent's argument to be that this result follows because *if* the form of the decree had not so recognized petitioner's position in equity, it might have been more costly for petitioner to redeem. We know of no authority for the creation of taxable income because in another form a transaction might have been less beneficial. The financial or economic benefit conferred (Resp. Br. p. 19) must then be the satisfaction of the rights of the defendants as determined by the Oregon Supreme Court. By constant repetition (Resp. Br. pp. 12, 13, 16, 17, 18, 21) respondent seeks to establish the fallacy that petitioner obtained satisfaction of some amount or something *owed* by him to the defendants. It is clear that the substance of the litigation was a determination of the rights of the parties in the property and its income. The fact that defendants were permitted to retain *all* of the earnings under a *ratio decidendi* which supported this holding by a finding of a judicially created "lien" in their favor did not create any debt *"owing"* by petitioner. Clearly then, if realities are to control and form be pierced to get at the real substance and real effect of what has been done (Resp. Br. p. 17), the most that can be deduced is that petitioner's property was freed from a "lien"—but an obligation not

owed by him and on which he had no personal liability of any kind.

The ultimate fact remains that the "credit" was not used to discharge or satisfy any indebtedness against the property which was a personal obligation of the petitioner. Therefore, as the cases cited in our main brief (pp. 22-23) hold, petitioner realized no taxable income by reason of the application of this credit. As is stated in 2 Mertens, Law of Federal Income Taxation, § 11.19, p. 79:

> "The rule that cancellation of the indebtedness may constitute the realization of income has been held to be limited to cases involving the reduction of a *personal* liability. Thus, the reduction of a mortgage not assumed by the taxpayer or the reduction of a special assessment against land has been held not to result in the receipt of taxable income."

Respondent recognizes this rule of law but boldly states that "* * * this principle is not applicable here." However, respondent's argument in support of non-application of this long-settled rule is not convincing. In essence, the contention is made that the *Murray v. Wiley* litigation and accounting "* * * should be regarded as if the taxpayer had recovered a judgment for the rents and interest." (Resp. Br. p. 12). Also, it is stated this case "* * * more accurately and realistically [involves] the receipt of amounts owing by the mortgagees to the taxpayer (in effect received by the taxpayer through the accounting device as taxable rents and interest) and their application against the larger amount owing [sic] by the taxpayer to the mortgagees" (Resp. Br. p. 21). The misleading character of this last

statement is obvious, for in this case petitioner owed nothing whatsoever to the mortgagees.

Respondent's effort to twist the *Murray v. Wiley* litigation into an action at law by petitioner to recover rents and profits brings to mind a recent admonition by the Court of Appeals for the Fifth Circuit in *Davis v. Penfield,* 205 F. (2d) 798, 802, that "* * * strained and artificial constructions in tax cases of law or fact will be avoided * * *".

Although unsupported by either reason or authority, respondent attempts to argue that the leading case in point on this problem, *Hilpert v. Commissioner,* 151 F. (2d) 929 (C.A. 5), "should not be followed, and that the dissenting view of Judge Hutcheson therein (p. 934) sustaining on principle the taxability of the credit of the mortgagor, is the correct view" (Resp. Br. p. 22). We will not prolong this brief by again discussing the *Hilpert* case (Pet. Br. pp. 23-25). We only point out that inasmuch as respondent failed to ask the United States Supreme Court to review the Fifth Circuit's decision, he is hardly in a position to urge this Court to disregard it. If the *facts* of that case create a distinction because of the hardships a different result might have produced for that taxpayer, they certainly created no greater equity than here where respondent's argument would crown petitioner's nine years of litigation to recover his property with confiscation of rentals he never received by pyramiding them in the high surtax year of 1947 and depriving him of the benefit of his accumulated depreciation for the same period, which of course can only be taken annually. (21 T.C. at p. 1062).

II.

If taxable at all, the full amount of the net rentals and interest credited to petitioner did not constitute taxable income in 1947.

On this alternative ground, respondent attempts to answer petitioner's argument by pointing out that the Watters group could not have collected the net rentals in the year 1942 and thereafter as agents for petitioner because the requisite element of consent to an agency relationship between the parties was absent (Resp. Br. p. 26).

This argument does not meet the issue here. As we pointed out in our opening brief, the 1942 decisions of the Oregon Supreme Court so conclusively established petitioner's right to receive or be credited with the net rentals from the Murray Building that the Watters group who were adjudged to be mortgagees in possession could thereafter have no valid claim of right to such receipts. As respondent must concede (Resp. Br. p. 26), the mortgagees in possession were required by Oregon law to apply the net receipts against their lien indebtedness (see *Caro v. Wollenberg,* 83 Or. 311, 163 P. 94, and *Investors Syndicate v. Smith,* 105 F. (2d) 611 (C.A. 9). We did not argue that the mortgagees in possession were agents by virtue of contract, as respondent mistakenly assumes, but that they were "in the position of agents for petitioner" under a court imposed duty to account to him for the funds received (see Pet. Br. p. 29).

Perhaps it would also have been accurate to have termed the mortgagees in possession as quasi or constructive trustees for petitioner (see 59 Corpus Juris Secundum (Mortgages, Sec. 318) p. 427; 36 American Jurisprudence (Mortgages, Sec. 301), p. 841). In *Russell v. Southard,* 12 How. 139, 155, 13 L. Ed. 927, the United States Supreme Court stated: "A mortgagee in possession is deemed by a court of equity a trustee." As pointed out by the Restatement of Agency (Vol. 1, Sec. 15, p. 23), an agency relationship differs from a trust relationship since the beneficiary may not have created or consented to the trust.

However, irrespective of whether the mortgagees in possession were "agents" of petitioner or merely "quasi or constructive trustees" under a duty to apply receipts to the satisfaction of their liens against petitioner's property, their receipt of funds was equivalent to receipt by petitioner. This must particularly be true if the law required the mortgagees in possession to credit the receipts upon amounts which respondent says in the first facet of his argument were *owed* to them by petitioner. If the receipts were in fact taxable income, they were taxable to petitioner in the years of collection and not all in one lump sum in 1947.

So in *S. B. Tressler,* T.C. Memo Docket Nos. 29044 and 35129 (1953) (Sec. 53.111 P.H. Memo T.C. 53-353) it was held that receipts from petitioner's property collected by a receiver in possession and applied upon the taxpayer's obligations to his wife were taxable in the year of collection.

The principle was also followed by this Court in *Parkford v. Commissioner,* 133 F. (2d) 249 (C.A. 9), cert. den. 319 U.S. 741, 63 S. Ct. 1029, 87 L. Ed. 1698, where money received by a trustee in bankruptcy on account of services previously rendered by the bankrupt taxpayer was held to be taxable income of the taxpayer in the year of receipt by the trustee in bankruptcy.

Respondent also argues that in any event no income accrued to petitioner until 1947 because of the contingency of his paying the balance found to be due to the mortgagees in possession under the accounting. He states (Resp. Br. p. 24) that "the actual credit itself was contingent upon the payment of the balance owing the mortgagees." From this it may be inferred that if petitioner had not redeemed the defendants would not have retained the amount of their "credit". Nothing in the record supports this inference. It is clear that defendants in all events were held to be entitled to retain the appropriated earnings. This result would not be affected by the contingency of whether petitioner would or would not redeem by making payment of $10,640.31. To analogize that petitioner in 1947 acquired the "right to demand payment of the rents from the property and convert them to his own use" (Resp. Br. p. 27) implies an option which petitioner never had. If, as is the fact, petitioner had no right to receive the rentals because the law required the mortgagees to apply them as received to an obligation which respondent says petitioner owed to them, it is axiomatic that such annual satisfaction of petitioner's debt by moneys which would have been

taxable if paid directly to him constituted his income as received and applied by the mortgagees.

Thus, petitioner respectfully submits that while there was uncertainty as to the nature of the receipts collected prior to 1942 by the mortgagees for application to the extinguishment of liens against his property or petitioner's debt, if such it be, the substantial contingency as to petitioner's right to be credited with such income was completely removed by the decisions of the Oregon Supreme Court in 1942.

Thereafter, if the net receipts of the building constituted taxable income to petitioner, they were taxable to him in the year of receipt by the mortgagees in possession.

CONCLUSION

The Tax Court of the United States erred and its decision should be reversed by this Court.

Respectfully submitted,

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